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Interpreting Financial Statements and Accountants' Reports for Credit Purposes

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I should like at the outset to express my appreciation for having been invited to appear before this audience. I always consider it a distinct honor to address a business group and I take particular pleasure in having the opportunity of speaking to a group of credit executives. After all, a CPA's principal product is his report on financial statements and among the principal users of this commodity are the credit executives of the country. The accountant is the expert in the form and content of financial statements and in the conduct of an audit leading up to his opinion on them. The credit executive is the expert in analyzing them and in diagnosing the financial ills of a company through such analysis. Understanding the financial statements and the accountant's report from the point of view of the accountant should help the credit executive in his analysis and interpretation.

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Being requested to speak in the Poconos reminds me of a talk I gave about four years ago to a group of executives at Skytop, which is about ten miles from here. On the day I spoke, the program called for business sessions in the morning only. The entire afternoon was to be devoted to a golf tournament. I was the last scheduled speaker in the morning and had been asked to speak for about 45 minutes. The speakers preceding me took somewhat more time than had been allotted to them, so that it was about a quarter to twelve when the chairman rose to introduce me. Before doing so, however, he reminded the audience of the importance of teeing off promptly so that the tournament could be completed in ample time for the evening reception. He then urged them to try to get to the dining room for lunch as near to noontime as possible so as not to delay the start of the tournament. Finally, and it was then ten to twelve, he introduced me and stated that my topic would be the development of friendly relations in business contacts. I remained friendly with the audience. Needless to say, my prepared speech on the subject was not delivered.

Before accepting Ken Smith's kind invitation to appear here today, I had him promise that I would not be in direct competition with a golf tournament.

FINANCIAL STATEMENT AS THE BASIS FOR CREDIT

Through the years much has been written concerning the analysis and interpretation of financial statements. Much has also been written regarding their content. Rarely, however, are both subjects discussed together. Most works on statement analysis devote considerable attention to the relationships of amounts appearing in the statements but, in my opinion, fail to emphasize sufficiently the importance of evaluating the amounts themselves. For example, we know that the relation of current assets to current liabilities is commonly referred to as the current ratio and is used to measure an enterprise's ability to meet its current obligations. Before accepting this ratio as an accurate measure, however, should we not ask ourselves, "How reliable are the amounts shown in the balance sheet for current assets and for current liabilities?" Or, even if we are satisfied with the reliability of the financial statements, should we not inquire regarding the bases upon which the various items are stated? As an illustration, an inventory priced on an average-cost basis might differ considerably from the same inventory priced on the last-in, first-out basis.

Failure to give adequate consideration to the disclosures in footnotes to financial statements and in the accountants' reports accompanying them can result in serious misinterpretations. I am familiar with one situation where the loan officer of a commercial bank extended substantial credit on the basis of the borrowing company's financial statements. These showed a substantial net worth, adequate working capital, and good earnings. In all respects, the loan officer's analysis indicated the company to be a good credit risk. In less than six months it was bankrupt. The danger of such an occurrence should have been obvious to the loan officer at the time he made the loan, because the footnotes stated that the company was a defendant in a patent infringement suit brought by a competitor who was seeking damages in an amount that was greater than the total net worth of the company. The footnotes stated further that in the opinion of general counsel for the company it was not possible to estimate the company's eventual liability as a result of the litigation. I am sure, that if the loan officer of the bank had read this footnote, he would have been far less willing to extend substantial credit.

In another case, also concerning extension of credit by a commercial bank, it appeared that the company seeking credit was in excellent financial health. The accountant's report accompanying the financial statements, however, seriously questioned the valuations placed on the inventories and receivables, by far the two largest assets in the balance sheet. The accountant pointed out that, although many of the accounts receivable were long past due, no reserve for bad debts had been set up. As to the inventories, he mentioned that no physical inventories had been taken by the company in over two years, during which period the amounts of inventories as shown by the books were constantly increasing. Subsequent events proved the accountant's exceptions to have been worth heeding. Many of the receivables proved to be uncollectible. When a physical inventory was finally taken it developed that as a result of careless bookkeeping much of the inventory that had been sold had never been removed from the inventory account on the books and consequently the inventory was substantially overstated. The bank considered itself fortunate to work out of this situation finally, but did so only after several years, during which time it was an unwilling partner in a marginal operation.

While on the subject of commercial banks I am reminded of the story of the immigrant who heard on television how easy it was to obtain a personal loan. Needing cash, he dropped by the local branch of the bank and stated that he wanted a loan. He was told that he would have to wait about an hour, because the loan arranger was out to lunch. After a moment's thought, he asked, "Well, then can I speak to Tonto?"

RELIABILITY

In statement analysis, one of the first matters to be considered is the reliability of the financial statements. Are they correct? Or, are they inaccurate or misleading? A number of factors can be responsible for false or misleading statements. There may be a deliberate attempt to misrepresent the financial health of the enterprise. Or the individuals keeping the books and preparing the statements may be insufficiently trained in accounting matters, with the result that solely through ignorance and incompetence the statements may be entirely misleading. Another possibility is that the statements may reflect an attitude of the owner of the enterprise that is not justified in the circumstances. Such would be so where the owner optimistically expects to sell merchandise that has been on his shelves for three years and consequently makes no write-down of the inventory.

It is not always possible to make an intelligent appraisal of the reliability of financial statements. On the other hand, however, there are many instances where the reader can feel justified in relying upon them. If a company is known to be highly reputable and to have a competent accounting department, its financial statements are probably reliable. A reasonable presumption is that audited statements are more reliable than those that are unaudited. However, the mere presence of an accountant's or auditor's report is no assurance that the financial statements have been audited or, if audited, that the auditor agrees that they properly portray the financial health of the enterprise. In order to determine the extent of the audit and the auditor's conclusions, it is necessary to read his report carefully.

ACCOUNTANT'S REPORT

I should like at this point to spend a few minutes describing the standard auditor's or accountant's report.

Various terms are used pretty much interchangeably to describe the auditor's report, and the particular term used in any specific case generally depends upon the auditor's preference. It may be called "Accountants' Certificate," "Auditors' Certificate," "Accountants' Report," "Accountants' Opinion," "Opinion of Independent Public Accountant," or any one of several other names; or, it may bear no heading at all. Its title is not important; its content is.

The standard accountant's report accompanying financial statements contains two principal sections. One of these, commonly referred to as the "scope" section, contains a description of the examination made by the auditor. The other principal section of the report is generally termed the "opinion" section and contains the auditor's conclusions as a result of his examination. Most auditors present the "scope" and "opinion" sections in separate paragraphs, although a few combine them in a single paragraph. Additional paragraphs are sometimes used to elaborate on the scope of the examination, to state any exceptions or qualifications which the auditor may have, or to present comments on certain items in the financial statements. In any event, however, the report should always include the "scope" and the "opinion" sections. The absence of either or both constitutes a violation of the rules of professional conduct of the American Institute of Certified Public Accountants. An exception to this rule is where the auditor has prepared the financial statements from the books without audit, but here again, he is obliged under the rules of professional conduct to indicate this fact in his report or on the face of the financial statements themselves.

The American Institute of Certified Public Accountants has promulgated these various rules primarily to protect the reader of financial statements. Otherwise, the reader might be misled into believing that the statements have been audited in accordance with generally accepted auditing standards, when in fact they have not, or else, in the absence of a specific opinion by the auditor, the reader might conclude that the auditor is satisfied that the statements present fairly the financial picture of the enterprise, whereas such may not be his opinion at all.

SCOPE OF EXAMINATION

Obviously, the auditor cannot express an unqualified opinion unless the scope of his examination is sufficiently extensive to provide him with the knowledge necessary to express an opinion. Where his examination has been sufficiently extensive, he will state in the "scope" section of his report that he has examined the financial statements and that his examination was made in accordance with generally accepted auditing standards. If his examination did not meet such standards, as, for example, if he did not observe inventories, he is required to state that fact in the "scope" section.

AUDITOR'S OPINION

The auditor's opinion may be unqualified or qualified. Or, if because of the limited extent of his audit or for other reasons, he cannot express any opinion, he must specifically disclaim an opinion on the financial statements as a whole and indicate clearly his reasons for disclaiming an opinion.

Where an auditor's examination has been sufficient to enable him to express an opinion and he has no reservations, he will state that it is his opinion:

(a) that the financial statements present fairly the financial position and results of operations of the enterprise,

(b) that the statements are presented in accordance with generally accepted principles of accounting, and

(c) that such principles have been consistently observed.

As previously mentioned, if the auditor's examination was of inadequate scope or if he cannot satisfy himself that the financial statements fairly portray the enterprise's financial picture, he must qualify his opinion or disclaim an opinion entirely.

Qualifications

Any qualifications to the auditor's opinion should be stated in his report or reference made in the report to the financial statements or their footnotes where the matter is explained. The explanations should be sufficiently clear to enable the credit executive or any other reader of the financial statements to understand fully the auditor's position.

Qualifications that relate to the scope of the auditor's examination usually indicate merely that he has not satisfied himself fully regarding the financial statements; they do not mean that the auditor is taking exception but only that he has an insufficient basis for judgment. Some other types of qualifications, however, disclose that the auditor does not believe that the financial statements present fairly the financial information. For example, the auditor may point out that no provision has been made for obsolete or slow-moving merchandise although a substantial portion of the total inventory may be represented by such merchandise. Or, he might state that the provisions for depreciation are inadequate and that if adequate provisions were made the enterprise's profit picture might be considerably altered. In still other cases, the auditor's qualifications may represent disclosures of events that may have a pronounced effect on the enterprise's financial condition but the extent of such effect is not now known. A situation of this type would be my earlier illustration of the company that was a defendant in a lawsuit involving alleged patent infringement. In that case the auditor was able to disclose the existence of the lawsuit, was able to state the amount of damages being sought, and was able to state what the company's general counsel thought on the matter. He could not make any prediction about the outcome of the litigation or its effect on the company's financial condition. Accordingly, in a case such as this, his opinion would be so worded as to indicate clearly that it was subject to the effect on the financial statements that the outcome of the lawsuit would have.

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Before leaving the subject of accountants' reports and proceeding to a discussion of the evaluation of items appearing in financial statements, I should like to recap briefly the principal points regarding accountants' reports on financial statements. They are these:

1. If the accountant has prepared the financial statements from the books without auditing them, he must state that fact clearly, either in his report or on the financial statements themselves.
2. There should be included in his report a "scope" section, describing his examination and indicating whether it was made in accordance with generally accepted auditing standards.
3. His conclusions, as a result of his audit, should be expressed in the "opinion" section of the report. These conclusions may take the form of an unqualified opinion, a qualified opinion, or a disclaimer of an opinion. Where an unqualified opinion is not given, the accountant must explain why. These explanations are known as his exceptions or qualifications.

INTERPRETATION OF FINANCIAL STATEMENTS

Financial statements are an interesting subject for study. They have been in use for many centuries, although their present state of refinement has been achieved only in relatively recent times.

Since the advent of financial statements, the wealth of an individual is usually measured by what is shown in his balance sheet. It has not always been so. We can find many Biblical references to wealth, where an individual is described as owning so many cows, or so much land. We even find the number of wives owned being used as a measure of wealth. Today we would probably wonder how a man with more than one wife could remain solvent.

The basic difference between the ancient measures of wealth and those that we employ today is in the language used. The ancient equivalent of a balance sheet was a literal listing of a man's assets and liabilities. Such a listing might show that he possessed 12 acres of land, 100 gold pieces, and 50 sheep, and that he owed to his creditors 75 barrels of olive oil. Although this might be an accurate statement of his financial condition it certainly made the computation of net worth difficult. Can you visualize what the balance sheet of General Motors might look like if prepared along these lines? Obviously, the reader would become so involved in a mass of detail that he would in all probability be completely unable to make a reasonable evaluation of the company's worth. Today's financial statements represent our attempt to solve the problem of how to add apples and oranges and obtain something besides fruit salad. We try to express in terms of a common language all the items affecting the financial condition or results of operations of an individual or of an enterprise. For convenience, we have selected as this common language our monetary unit and have attempted to translate into this common language all the diverse items of assets, liabilities, income, and expense.

The difficulty of translating into dollars and cents the items entering into the financial statements varies with the nature of the item. Certain items require no translation, such as cash and sales, since these are already expressed in monetary units. Certain other items normally present very little difficulty, such as accounts receivable, where the amounts owing by the customers are stated in monetary units and the only adjustment required is to make appropriate allowance for uncollectible balances. The translation of still other items, however, can present difficulties. Let us take, for example, a merchant who purchases a thousand pounds of sugar during the year, of which a portion was purchased at 8¢ a pound and the remainder at 10¢ a pound. At what price should this merchant include in his balance sheet the sugar remaining in his inventory at the year end? At 8¢ a pound? At 10¢ a pound? At the average of the two prices? At the market price at the year end? Any one of these methods might be appropriate in particular circumstances.

ACCOUNTING PRINCIPLES

A body of principles has been developed that governs the methods to be used in stating various items in the financial statements. These are known as generally accepted accounting principles. They are not rigid rules; rather, they must be, and are, sufficiently flexible to meet the varying needs of different circumstances and situations found among business concerns. The basis of stating the various items in the financial statements of any enterprise is the result of the exercise of judgment on the part of the individual preparing the statements, working within the framework of these generally accepted principles.

ANALYSIS OF FINANCIAL STATEMENTS

Securities

I should now like to spend a few minutes discussing certain accounts that I believe the credit executive might wish to consider carefully when analyzing financial statements. First of all, let us consider marketable securities and other investments. These assets are usually recorded in the accounts at cost and are so carried in the balance sheet, unless the market value has declined since they were purchased. If the market decline is considered temporary, it is likely that no adjustment of the carrying value will be made. If, however, the decline appears permanent, the carrying value should be written down to market. On the other hand, it is not considered good practice to write up the values of investments to reflect higher current market values. For this reason, anyone analyzing financial statements that include marketable securities should look for some indication of the market value of the securities. I recently had occasion to review a balance sheet showing investments in securities carried at a cost of $156,000. The footnotes to the balance sheet disclosed that, based on current market quotations, these securities were worth in excess of $2,700,000, or more than two and a half million dollars more than the amount at which they were stated in the balance sheet. With the investments stated at cost this balance sheet showed current assets of $1,000,000 and current liabilities of $750,000, with a resulting net working capital of $250,000, and a current ratio of 4 to 3. Substituting the market value for the cost of the securities increased net working capital from a quarter of a million dollars to almost $3,000,000 and increased the current ratio from 4 to 3 to almost 5 to 1.

Inventories

Inventories can, and frequently do, present valuation problems. They should be stated in the balance sheet at the lower of cost or market. However, there are a number of methods of computing cost, each of which is perfectly proper but each of which may produce an entirely different inventory valuation. The principal methods of computing cost are the first-in, first-out method, the various average cost methods, and the last-in, first-out method, the last-named generally being referred to as the LIFO method. In order to avoid becoming too involved in detail, let me say merely that most methods, other than the LIFO method, usually produce substantially similar inventory valuations which normally reflect recent actual costs. The LIFO method, on the other hand, assumes that the most recently acquired goods are the first to be used. The distinctive feature, and advantage, of this method is that current operations are charged with current costs, thus placing the sales figures and the cost of goods-sold figures on a comparable basis. An incidental result, however, may be an inventory valuation in the balance sheet which bears little or no relation to present costs.

Perhaps I can best demonstrate the effect of LIFO by citing an example. A manufacturer of chocolate adopted LIFO during the 1930's. At that time the price of coco beans, which is the principal raw material used in the manufacture of chocolate, was approximately 5 cents a pound. Accordingly, the company's entire inventory of coco beans was valued at that price. Since then the price of coco beans has steadily increased and I believe that the present price is somewhere in the neighborhood of 30 cents a pound. During this period the company charged its manufacturing operations with the current cost of coco beans, leaving the so-called "base stock" inventory valued at 5 cents a pound. This resulted in more meaningful income statements. The company's cost of goods sold included current costs, as also did its sales, since the prevailing selling price for chocolate fluctuates with fluctuations in the price of coco beans. Under another inventory pricing method it is probable that each year's cost of goods sold would have reflected, at least to some extent, the prior year's cost of coco beans whereas the sales would have reflected the current market prices.

The use of LIFO by this chocolate company presumably improved the quality of its income statements. In analyzing its balance sheet, however, recognition must be given to the LIFO method of valuing inventories. The substantial quantities of coco beans in its inventory are stated at 5 cents a pound whereas the current market price is six times that amount.

Whenever in analyzing financial statements you see that the inventories are stated on LIFO, you should recognize that the inventory valuations may not represent current costs. Generally, where there has been a rising market since the adoption of LIFO by the company, the inventory valuation on LIFO will be less than current values. Conversely, where there has been a falling market, LIFO values may be higher than current values. The extent to which LIFO valuations differ from current valuations will depend on the sharpness in the rise or decline in the market and the length of time that has passed since the company adopted LIFO.

Fixed Assets and Depreciation

Fixed assets and the related depreciation accounts perhaps warrant as much attention from the credit executive as any other accounts in the financial statements.

Possibly in no other area is it so important to look behind the financial statements. Some of the factors to be considered are high-cost property versus low-cost property, appraised values as opposed to cost values, and methods of computing depreciation.

As we all know the past twenty years have seen a steady and sharp increase in the general price level in this country. The five-cent cup of coffee and the nickel glass of beer have vanished. When viewing most items in financial statements this price rise can be ignored since most of these items are stated in terms of current dollars and their equivalent in terms of, say, 1939 dollars would be of academic interest only. This is not so in the case of the property and related depreciation accounts. Here it is necessary to take cognizance of the rise in the general price level from the date the assets were acquired if we are to make an intelligent appraisal of the financial statements. The property of an enterprise, unlike most of its other assets, remains in the enterprise over a relatively long period, during which pronounced changes in the price level may occur. Inventories and receivables usually turn over several times a year. Machinery and equipment, on the other hand, may turn over only once in a score of years and buildings maybe only once or twice in a century. As a consequence, the property accounts appearing in a balance sheet may be stated in terms of 1941 dollars or even 1910 dollars.

As an illustration, let us assume that Company X is conducting its operations in a building constructed in 1915 at a cost of $500,000 which is being depreciated at the rate of $10,000 a year over its estimated life of 50 years. Now let us assume that a competitor, Company Y, constructed a building, similar in all respects, except cost. This building, having been built in 1956, cost $3,000,000 and its annual depreciation, also on a 50-year life, amounts to $60,000. Let us now compare the financial statements of companies X and Y. Although both companies are using substantially identical facilities, Company Y's annual operations are saddled with a cost of $60,000 for depreciation of its building, while Company X's building depreciation is only $10,000. Allowance for this difference should be made when comparing the profit results of the two companies. Also, it should be recognized that Company X's annual depreciation costs will presumably increase sharply at such time as it becomes necessary to replace its present building.

The balance sheet, as well as the income statement, is affected by low-cost property. We have just seen how it can result in lower depreciation costs and consequently higher reported profits in the income statement. It will also result in the property's being stated in the balance sheet at an amount that is less than its present worth in terms of current-day dollars.

Depreciation Methods

The method a company adopts for computing depreciation can affect substantially the net amounts at which its property is stated in the balance sheet and can have an even more pronounced effect upon its results of operations as shown in its income statement. Most companies use either the straight-line method of depreciation or one of the accelerated methods. The straight-line method results in equal annual depreciation charges over the estimated useful life of an asset. The accelerated methods provide for higher depreciation charges during the early years of an asset's estimated useful life and lower charges in the later years. Accordingly, when analyzing financial statements consideration should be given to the company's method of taking depreciation. For example, if a company's fixed assets have been recently acquired and it is using an accelerated method of depreciation, the reader of the financial statements should recognize that the net profit reported in the income statement is less than it would have been had a non-accelerated method, such as the straight-line method, been employed. He should also recognize that depreciation charges will decrease in future years to the benefit of future earnings.

Extraordinary Items

I should next like to mention the matter of extraordinary items in the income statement. In determining the profitability of an enterprise it is not sufficient to look at the net income or net loss figure appearing at the bottom of the income statement. The net income for any particular period may be materially influenced by extraordinary, non-recurring items. For example, an income statement which I recently read showed a net income for the year of approximately \$700,000. However, one of the items entering into the determination of this net income was a profit of over a million dollars arising from the sale of one of the company's plants. Excluding this non-recurring item, the company had a net loss of over \$300,000 for the year. This merely illustrates the need for considering all of the items in the income statement, and not merely the amount shown for net income.

Where a company is operating at a loss it is usually desirable for purposes of credit analysis to consider its income tax status. Under the carry-back and carry-over provisions of our income tax law, a net operating loss in one year may be offset in computing income tax against profits of the three preceding years or the five succeeding years. Where a loss is carried back to an earlier year, the taxpayer is entitled to a refund of a portion or all of the taxes paid for such earlier year. In these circumstances, the company's income statement for the year in which it suffered the loss would include a credit for the amount of the anticipated tax refund. For example, if a company had a loss of \$1,000,000 before taxes and by carrying this loss back was entitled to a refund of income taxes in the amount of \$520,000, it would end up with a net loss of \$480,000 for the year. On the other hand, if it had paid no income taxes for the prior three years it would be entitled to no refund and would show the full \$1,000,000 as its net loss for the year. However, it would have a hidden asset which might or might not have value, depending upon the company's future profitability. This hidden asset would be the carry-over loss. Thus the first \$1,000,000 of net income during the next five years would in effect be received tax-free.

CONCLUSION

In my comments today I did little more than touch on a few points on the subject of financial statements and accountants' reports. Were I to speak for another three days, however, I would still barely scratch the surface. At the same time, I hope that some of you may have gained some little knowledge from my talk that may someday be of help to you. Again, I wish to thank you for the opportunity of meeting the members of your conference and of speaking to you today. I shall now be pleased to answer, or at least try to answer, any questions you may have.